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5 September 2018

Dear [REDACTED]

Subject: Audit of Bodycote PLC – climate change-related trends and risks

We are writing to you in your capacity as the senior statutory auditor responsible for Deloitte LLP's (**Deloitte**) audit of Bodycote PLC's (**Bodycote**) 2017 Annual Report and Accounts (**Annual Report**).

On 7 September 2018, we intend to submit a complaint to the Financial Reporting Council (**FRC**) in relation to Bodycote's Annual Report (**Complaint**). In the Complaint (draft included with this letter), we submit that by failing to refer to climate change or the low carbon transition in relevant sections of its Annual Report, Bodycote has failed to provide an adequate description of:

- the principal risks and uncertainties facing its business;¹
- the main trends and factors likely to affect the future development, performance and position of its business;² and
- the long term viability and prospects of the company in light of these risks and trends.³

As an international engineering services provider and industrial manufacturer with an energy intensive business model, Bodycote's business is materially exposed to the trends and risks associated with climate change and the low carbon transition. As detailed in the Complaint, such trends and risks have now been widely recognised by investors, governments, regulators and many of Bodycote's peers.

However, other than the mandatory disclosure of greenhouse gas emissions for which the company is responsible and a general discussion of its carbon emissions in a 'corporate

¹ Companies Act, s 414C(2)(b); DTR 4.1.8 R.

² Companies Act, s 414C(7)(a).

³ LR 9.8.6, Corporate Governance Code [C 2.2].

responsibility' section, Bodycote's Annual Report makes no reference at all to any risks or trends associated with climate change or the low carbon transition. Accordingly, as detailed in the Complaint, it is our view that Bodycote's Annual Report has not been prepared in accordance with the applicable legal requirements and contains material misstatements by virtue of its omission of this information.

Deloitte's audit

In Deloitte's report to Bodycote's members in the Annual Report (**Audit Report**), Deloitte states that:

- *'[i]n our opinion, based on the work undertaken in the course of the audit: ... the strategic report and the directors' report have been prepared in accordance with applicable legal requirements'; and*
- *'[i]n light of the knowledge and understanding of the Group and of the parent company and their environment obtained in the course of the audit, we have not identified material misstatements in this information.'*⁴

In our view, in carrying out the work necessary to provide these opinions in compliance with the relevant audit standards (**ISAs**), the matters raised in our Complaint should have been picked up by Deloitte and discussed with Bodycote's management and/or its audit committee.

In this regard, we note that Deloitte has publicly signed up as a supporter of the Task Force on Climate-related Financial Disclosures (**TCFD**) and has published extensively on the topic of climate change-related risks and their financial implications. Many of Deloitte's other audit clients also include significant discussions of climate change-related trends and risks in their own annual reports.

In light of recent changes to the Companies Act, statutory auditors now have a critical role to play in providing investors with assurance (to the standard set by relevant ISAs) that information disclosed by companies about trends and risks facing their business is prepared in accordance with the relevant legal requirements, is free from material misstatements, and is otherwise fair, balanced and understandable.

In our view, this should necessarily entail a consideration of material climate change-related trends and risks facing a company, including whether such trends and risks might have implications for assumptions and estimates used in preparing financial accounts themselves.

Whilst we are rightly not aware of the discussions which took place between Deloitte and Bodycote as part of the audit process, in our view, Bodycote's failure to provide a substantive discussion of climate change-related trends or risks in its Annual Report indicates that these matters may not have been robustly addressed in the audit.

⁴ Bodycote PLC Annual Report and Accounts 2017, p 83. We note that Deloitte is required to provide these opinions under s 496 of the Companies Act and ISA (UK) 720.

In order to bring these matters to your attention we have set out in an appendix to this letter what we consider to be the most relevant requirements under the applicable ISAs. We have also set out below a number of questions related to these requirements, which we would appreciate your response to.

Questions for Deloitte

1. What processes and procedures does Deloitte have in place to ensure that its extensive institutional knowledge about climate change-related trends and risks and their financial implications are made available to audit teams and are included in standard audit programmes?
2. Does Deloitte agree that the trends and risks associated with climate change and the low carbon transition are relevant to obtaining an understanding of an entity and its environment, where that entity carries on an energy and GHG intensive business in the industrial manufacturing sector?
3. Does Deloitte consider that it is required as an auditor to assess the reasonableness of directors' judgments in relation to the information included in the strategic report and directors' report in order to determine whether the relevant legal requirements have been complied with?
4. What processes and procedures does Deloitte perform to identify material inconsistencies between information about trends and principal risks included in the strategic report and directors' report and Deloitte's knowledge about an entity's objectives and business risks obtained in the audit?
5. What processes and procedures does Deloitte perform to identify whether information about trends and principal risks included in the strategic report and directors' report is materially misstated?

We would be grateful for any response you can make in relation to these questions by 21 September 2018. Please note, we intend to make a copy of this letter public on our website and provide a copy to the FRC, along with our Complaint in relation to Bodycote.

If you would like to discuss the contents of this letter, please contact Daniel Wiseman (dwiseman@clientearth.org) or Alice Garton (agarton@clientearth.org).

Yours sincerely,

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Annex - Relevant audit standards and questions for Deloitte

It is our understanding that in carrying out the work necessary to provide its opinions in relation to the information contained in Bodycote's directors' report and strategic report, Deloitte is required to comply with relevant legal and professional requirements, including ISAs.⁵

We acknowledge that the standard of assurance required to provide these opinions does not amount to the level of 'reasonable assurance' applicable to the audit opinion provided in relation to the financial statements.⁶ Nonetheless, we understand that the relevant audit standards must still be followed in providing these additional opinions. In this respect, we consider the following requirements to be most relevant:

- the requirement to exercise professional scepticism and professional judgement in planning and performing the audit (ISA (UK) 200 [15], [16]);
- the requirement to obtain an understanding of Bodycote's objectives and strategies, and those related business risks that may result in risks of material misstatement (ISA (UK) 315 [11], [15], [16]);
- the requirement to obtain an understanding of the legal and regulatory requirements applicable to Bodycote's strategic report and directors' report and how Bodycote is complying with those legal and regulatory requirements (ISA (UK) 720 [12-1]); and
- the requirement to perform procedures necessary to identify: any material inconsistencies between Bodycote's strategic report and directors' report and Deloitte's knowledge obtained in the audit; and whether the strategic report and directors' report appear to be materially misstated in the context of Deloitte's understanding of the legal and regulatory requirements applicable to that information (ISA (UK) 720 [14-2], [15]).

Further details in relation to each of these requirements are set out below, along with questions to Deloitte in relation to the application of these requirements in the conduct of its audit.

Professional scepticism and professional judgement – ISA (UK) 200

ISA (UK) 200 sets out the overall objectives of the independent auditor and how the audit is to be conducted in order to comply with the ISAs in general. Under paragraphs 15 and 16 of ISA (UK) 200, Deloitte is required to plan and perform its audit with 'professional scepticism' and to exercise 'professional judgment'. Accordingly, Deloitte's audit staff are required to adopt 'a questioning mind' and to apply 'relevant training, knowledge and experience' to the conduct of their audit.⁷

In this context, we note that Deloitte has demonstrated extensive institutional knowledge about climate change-related trends and risks and their financial implications. Deloitte has publicly signed up as a supporter of the Task Force on Climate-related Financial Disclosures

⁵ See, The Statutory Auditors and Third Country Auditors Regulations 2016, regs 4(1)-(2) (SATCAR).

⁶ See ISA (UK) 200 [11]-[12].

⁷ See ISA (UK) 200, [13(l)].

(TCFD). Deloitte has also published extensively on the topic. To provide one example, in a recent report entitled ‘*Climate-related risk assessments and financial disclosures*’, Deloitte states that:

‘Deloitte helps organisations assess and disclose their climate-related risks and opportunities. Our expertise is based on transparent and robust methodologies aligned with the Task Force on Climate-related Financial Disclosures’ (TCFD) Recommendations and Guidance, published in 2017. The TCFD’s recommendations address four key pillars: governance, strategy, risk management and metrics & targets. They aim at promoting consistent “disclosures that will help financial market participants understand their climate-related risks.”⁸

In another report, entitled ‘*Climate-related disclosure: Integrating climate-related information in the annual report*’, Deloitte states that:

‘Directors and senior management are responsible for providing a “full, accurate and timely disclosure of financial results, risk and other information which is material to investors’ decisions.” Investors use a broad set of information about how a company does business and whether its operating model is sustainable, and how it is managing (and mitigating) risks and opportunities associated with emerging policy areas, including climate change.

When climate-related risks and opportunities are material to the understanding of an organisation’s financial position, financial performance and cash flows, its business model, risk management strategies and its ability to continue to create long-term economic value, they should be discussed in an organisation’s securities market filings.⁹

In light of these examples, Deloitte appears to hold itself out as having ‘relevant training, knowledge and experience’ to consider and address climate change-related trends and risks in the conduct of its audit. In our view, in applying professional scepticism and professional judgment in accordance with paragraphs 15 and 16 of ISA (UK) 200, this expertise must be put into practice.

Question 1: What processes and procedures does Deloitte have in place to ensure that its extensive institutional knowledge about climate change-related trends and risks and their financial implications are made available to audit teams and are included in standard audit programmes?

Objectives, strategies and business risks – ISA (UK) 315

ISA (UK) 315 deals with the auditor’s responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity’s internal control. Under paragraph 11 of ISA (UK) 315, Deloitte is required to obtain an understanding Bodycote’s ‘industry, regulatory, and other external factors’ and Bodycote’s ‘objectives and strategies, and those related business risks that may result in risks of material misstatement.’ Under paragraphs 15 and 16 of ISA (UK)

⁸ Deloitte, ‘*Climate-related risk assessments and financial disclosures*’ (June 2018).

⁹ Deloitte, ‘*Climate-related disclosure: Integrating climate-related information in the annual report*’ (2017)

315, Deloitte is also required to understand and assess Bodycote's risk management and internal control processes.

Accordingly, this will require Deloitte to consider industry conditions and technological developments; market demand and pricing for Bodycote's products; energy supply and costs; the relevant regulatory environment, including legal and political developments; government policies, including financial incentives and tariffs or trade restrictions; and environmental requirements.¹⁰

Section 3 of the Complaint sets out evidence as to why climate change-related trends and risks represent significant risks for Bodycote's business. As noted in the Complaint, these risks are recognised by many of Bodycote's peers.

In light of this evidence, in our view, Deloitte should have considered the risks and trends associated with climate change and the low carbon transition when obtaining an understanding of Bodycote and its environment in accordance with ISA (UK) 315.

Question 2: Does Deloitte agree that the trends and risks associated with climate change and the low carbon transition are relevant to obtaining an understanding of an entity and its environment, where that entity carries on an energy and GHG intensive business in the industrial manufacturing sector?

Legal and regulatory requirements for 'other information' – ISA (UK) 720

ISA (UK) 720 deals with the auditor's responsibilities relating to 'other information' included in the Annual Report, including a company's strategic report and directors' report. Under paragraph 12-1 of ISA (UK) 720, Deloitte is required obtain an understanding of the legal and regulatory requirements applicable to the 'other information' and how Bodycote is complying with those requirements.

Section 4 of the Complaint sets out our submissions as to why Bodycote's strategic report and directors' report do not comply with the relevant legal and regulatory requirements applicable to that information.

In summary, in our view, a reasonable director in the position of Bodycote's directors would have considered that the risks and trends associated with climate change and the low carbon transition would be material to a shareholder's understanding of the development, performance, position or future prospects of Bodycote's business – and would have disclosed this information in its annual report accordingly.¹¹

Accordingly, in our view, in order to determine whether or not the strategic report and directors' report have been prepared in accordance with the relevant legal requirements as required by ISA (UK) 720, Deloitte would need to consider and assess the reasonableness of directors' judgments in relation to that information.

Question 3. Does Deloitte consider that it is required as an auditor to assess the reasonableness of directors' judgments in relation to the information included in the strategic

¹⁰ ISA (UK) 315, [A24-A29].

¹¹ See relevant guidance contained in: FRC, Guidance on the Strategic Report 2014, [7.24]-[7.25] (as in force at the relevant time).

report and directors' report in order to determine whether the relevant legal requirements have been complied with?

Misstatements in the 'other information' – ISA (UK) 720

Under paragraph 14-2 of ISA (UK) 720, Deloitte is required to perform such procedures as are necessary in Deloitte's professional judgment to identify: any material inconsistencies between the 'other information' and Deloitte's knowledge obtained in the audit; and whether the 'other information' appears to be materially misstated in the context of Deloitte's understanding of the legal and regulatory requirements applicable to that information. Under paragraph 15 of ISA (UK) 720, Deloitte is also required to remain alert for indications that the 'other information' appears to be materially misstated.

Relevantly, ISA (UK) 720 states that *'[a] misstatement of the other information exists when the other information is incorrectly stated or otherwise misleading (including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information)'*.¹²

Section 4 of the Complaint sets out our views as to why Bodycote's failure to refer to climate change or the low carbon transition in its Annual Report is a breach of its legal duties. In light of the submissions set out in our Complaint, it is our view that the strategic report and directors' report included in Bodycote's Annual Report have not been prepared in accordance with the applicable legal requirements and contain material misstatements by way of omission.

Accordingly, in our view, in order to comply with the requirements of ISA (UK) 720, Deloitte is required to have appropriate processes and procedures in place to identify material inconsistencies between information about trends and principal risks included in the strategic report and directors' report and Deloitte's knowledge about an entity's objectives and business risks obtained in the audit, and also to identify material misstatements in light of this knowledge.

Question 4. What processes and procedures does Deloitte perform to identify material inconsistencies between information about trends and principal risks included in the strategic report and directors' report and Deloitte's knowledge about an entity's objectives and business risks obtained in the audit?

Question 5. What processes and procedures does Deloitte perform to identify whether information about trends and principal risks included in the strategic report and directors' report is materially misstated?

¹² ISA (UK) 720 [12(b)].